

Financial Management and Governance Issues in the People's Republic of China

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Prepared Under Regional Technical Assistance (RETA)
5877: *Strengthening Financial Management and Governance in
Selected Developing Member Countries.*

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Foreword

This report describes financial management and governance arrangements in the People's Republic of China, identifies deficiencies in those arrangements, and presents recommendations to address those deficiencies. For the purposes of this study, financial management and governance arrangements are narrowly defined as being accounting and auditing arrangements and practices.

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This report should be read in conjunction with the Summary Report, which identifies and examines selected issues in relation to financial management and governance.¹

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Currency Equivalents

(as at 3 November 2000)

Currency Unit – Yuan (Y)

Y 1.00 – \$ 0.1208

\$1.00 – Y 8.2778

The currency is the Renminbi, while the currency unit is the Yuan. The exchange rate of the Yuan is determined under a managed floating exchange rate system.

Abbreviations

ADB	Asian Development Bank
ARD	Accounting Regulatory Department (Ministry of Finance)
AusAID	Australian Agency for International Development
CAPA	Confederation of Asian and Pacific Accountants
CASC	China Accounting Standards Committee
CICPA	Chinese Institute of Certified Public Accountants
CIIA	China Institute of Internal Auditing
CNAO	China National Audit Office
CPA	Certified Public Accountant
CPE	Continuing Professional Education
CSRC	China Securities Regulatory Commission
FFAAD	Foreign Funds Application Audit Department (CNAO)
GDP	Gross Domestic Product
IAS	International Accounting Standard
IFAC	International Federation of Accountants
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
MOF	Ministry of Finance
NAI	National Accounting Institute
NPC	National People's Congress
PBC	People's Bank of China
RETA	Regional Technical Assistance
SOE	State-owned Enterprise
TA	Technical Assistance
UNDP	United Nations Development Program

Notes

- (i) The financial year of all organizations, including the Government, ends on 31 December.
- (ii) In this report, \$ refers to US dollars.

Contents

EXECUTIVE SUMMARY	1
I. INTRODUCTION	9
1. Study Background.....	9
2. Objectives.....	9
3. Scope	10
4. Country Case Studies and Workshops.....	10
5. The ADB Focus on Financial Governance in the PRC	11
6. The People’s Republic of China.....	11
II. ACCOUNTING AND AUDITING IN THE PRC.....	15
Part One. Accounting.....	16
1. Introduction.....	16
2. Issues and Responses since 1979.....	16
3. The ‘Chinese Accounting System’	19
4. Financial Reporting Requirements.....	23
Part Two. Auditing.....	26
5. Introduction.....	26
6. Governing Laws and Regulations.....	26
7. Auditor Qualifications.....	27
8. The Chinese National Audit Office (CNAO).....	27
9. Chinese Institute of Internal Auditing (CIIA)	33
10. Public Accounting and Auditing Firms.....	34
III. PROFESSIONAL INFRASTRUCTURE	41
1. Introduction.....	41
2. Legal and Regulatory Framework.....	43
3. CICPA Structure and Financing.....	45
4. CICPA Membership and Entry Criteria.....	47
5. Continuing Professional Education (CPE)	50
6. Professional Ethics and Practice Supervision	51
7. CPA Legal Liability.....	52
IV. ACCOUNTING AND AUDITING STANDARDS.....	57
Part One. Accounting Standards.....	57
1. Introduction.....	57
2. New Uniform Accounting Systems (Financial Standard)	60
3. Accounting Standards.....	61
Part Two. Auditing Standards.....	70
4. Independent Auditing Standards (Business Enterprises)	70
5. Government Audit Standards.....	71

V.	ACCOUNTING AND AUDITING TRAINING	73
1.	Introduction.....	73
2.	Educational Coordination	73
3.	Higher Education.....	74
4.	The National Accounting Institute (NAI)	75
5.	The National Uniform Accountant Qualification	76
6.	Auditor Training.....	76
VI.	GOVERNMENT BUDGETING AND ACCOUNTING	77
1.	Introduction.....	77
2.	The Budget Cycle	78
3.	Legal Framework for Budgeting and Accounting.....	80
4.	Budgeting Roles and Responsibilities.....	80
5.	Accounting Bases.....	80
6.	Financial Reporting.....	80
7.	Budgeting and Reporting Developments.....	81
8.	Anti-Corruption Measures.....	82
VII.	DONOR ASSISTANCE	83
1.	Overview.....	83
2.	Coordination Mechanisms.....	84
3.	Asian Development Bank.....	84
4.	International Monetary Fund (IMF).....	89
5.	The World Bank.....	89
6.	United Nations (UNDP)	93
7.	Australia (AusAID)	93
8.	Canada (CIDA)	94
9.	Germany (GTZ)	94
10.	Others.....	95
VIII.	ISSUES AND RECOMMENDATIONS.....	97
	Part One. Where Donor Assistance Might be Appropriate	97
1.	Professional Supervision of CPA Firms (Quality Control)	97
2.	CPA Examination System Reform	98
3.	Organization for Accountants (Non-CPAs)	99
4.	National Uniform Accountant Examination System.....	100
5.	China Institute of Internal Auditing: Certification.....	101
6.	Development of CICPA Training Materials	101
7.	Plan for Strategic Development of the CPA Profession.....	102
8.	CNAO Training and Capacity Building.....	103
9.	CNAO: Computerized Audit Support Systems.....	104
10.	China Institute of Internal Auditing: Standards.....	105

11. Training for Accounting Lecturers and Professors.....	105
12. Development of Public Sector Accounting Standards.....	106
Part Two. Where External Assistance is Not Required.....	106
13. Conflicts between Standards and Regulations.....	106
14. CPA and CICPA Independence.....	109
15. Accounting Standard-Setting Body.....	109
16. The Availability of Professionally Competent CPAs.....	110
17. CPA Legal Liabilities.....	112
18. CPA Professional Ethics.....	113
19. Structure and Contents of Accounting Standards.....	114
IX. MAIN DEFICIENCIES AND ACTION PLAN	117
REFERENCES.....	119

Appendixes

Table of Appendixes.....	123
Appendix 1. Interviewees.....	124
Appendix 2. RETA-5877 (Regional Study) Information	127
Appendix 3. Administrative and Institutional Arrangements.....	130
Appendix 4. Regulatory and Legal Framework.....	137
Appendix 5. The Accounting Law 1985	142
Appendix 6. The Certified Public Accountants Law 1993	151
Appendix 7. CICPA Charter 1996	158
Appendix 8. Relevant Extracts from the Securities Law 1998.....	162

Executive Summary

Background

On 1 October 1949, Mao Zedong proclaimed the People's Republic of China (PRC) to an audience of 500,000 in Tiananmen Square. Shortly afterwards, central planning was introduced. Beginning in late 1978, the Chinese leadership began to move the PRC from a centrally-planned economy to a more market-oriented economy. To this end the authorities switched to a system of household responsibility in agriculture in place of the old collectivization, increased the authority of local officials and plant managers in industry, permitted a wide variety of small-scale enterprise in services and light manufacturing, and opened the economy to increased foreign trade and investment.

The PRC has made tremendous progress in poverty reduction, particularly over the last two decades. Twenty years ago, it was among the world's poorest countries, with 80 percent of the population living on incomes of less than \$1 a day and only a third of all adults able to read or write. In the 17 years from the launching of the PRC's economic reform program in 1978, the transition from a command to a market-based economy, helped fuel a remarkable average growth in GDP of 8 percent a year. Since then, growth has remained relatively strong and incomes have generally continued to rise. Now, only about 7 percent of the population between 15 and 25 years old is illiterate, and the PRC's high life expectancy and low infant mortality rates are envied by much richer nations. The PRC has made great strides in improving social welfare. Consumption has more than doubled and the poverty rate has declined, as 200 million Chinese living in absolute poverty have been raised above the minimum poverty line.

Prudent macroeconomic policy aided the PRC in adjusting to the Asian crisis. In 1999, growth slowed slightly and prospects are that a rate lower than the trend in the 1990s can be sustained in the medium term. The challenges will be continuing the reform process of opening the economy, improving state sector efficiency, addressing unemployment issues, and developing a legal and regulatory framework essential for efficient functioning of a market economy.

Developments and Challenges

The PRC had public accounting firms and an accountancy profession before the introduction of central planning. The Soviet accounting system, which catered to the needs of central planning, was adopted in

the 1950s. The system provided statistical information, and emphasized standardization and uniformity so that information could be compared across sectors and industries. Detailed instructions replaced professional judgment in the accounts-preparation process and public accounting firms and the accountancy profession were unnecessary.

The PRC's 1979 decision to align accounting practices with the needs of a mixed-market economy posed a number of challenges. First, bookkeepers numbered in the tens of millions but there were no qualified Certified Public Accountants (CPAs), let alone a professional accounting body. Second, financial information on the performance and position of organizations was not publicly available. In any case, this information did not meet international standards nor did it cater to the needs of investors or lenders. Third, the users of financial information (investors and creditors) were unfamiliar with what they should demand from organizations. Fourth, financial information was not independently verified (audited) to international standards. Fifth, the entire legal framework was geared to central planning and specified exactly what information should be produced, how it should be produced, and to whom it should be provided. Finally, the regulatory entities that generally exist in market economies to oversee financial disclosure practices, such as securities exchange commissions, did not exist.

Objectives and Responses

The PRC's continuing accounting reforms have three objectives. First, to standardize and rationalize financial reporting – this is expected to gradually improve the efficiency of business enterprises through associated improvements to financial management and control systems. Second, to transit from the Soviet accounting model to the western accounting model – the adoption of the western accounting model is expected to facilitate foreign direct investment in the PRC. Third, to gradually give business enterprises more discretion to design their own internal accounting and financial systems.

In the two decades since 1979, the PRC has made enormous strides in terms of developing an accounting infrastructure suitable to the needs of a market economy. The first accounting firm was established in 1981 as a subsidiary of a government organization – there are now around 4,800 accounting firms. In 1985, the first *Accounting Law* was enacted which set out accounting responsibilities and procedures for state-owned enterprises. The Chinese Institute of Certified Public

Accountants (CICPA) was established in 1988 – it now has 135,000 members. The first IAS-based accounting standard was promulgated in 1992. In 1997, a vigorous ‘Rectification Campaign’ was conducted to improve professional practices and ethics. By the campaign’s end in 1999, 12,700 individual CPAs and 580 CPA firms had been forced from the profession.

Accounting and Auditing in the People’s Republic of China

The ‘Chinese accounting system’ is governed by the recently amended *Accounting Law 1985*, which sets out accounting arrangements, responsibilities and procedures. The Accounting Law serves as the ‘constitution’ for the school of accounting regulations and defines the accounting and reporting practices for all public and private sector organizations. Furthermore, ‘Uniform Accounting Systems’ and ‘Accounting Standards for Businesses’ determine accounting and financial reporting practices. The Uniform Accounting Systems prescribe charts of account, reporting formats and detailed accounting instructions. The ‘Accounting Standards for Businesses’ are based directly on IASs. All organizations use double-entry bookkeeping and prepare balance sheets. In these respects, PRC government accounting is more advanced than most developed countries.

The *Audit Law 1994* governs auditing in the PRC and defines the basic principles for government auditing supervision, government audit institutions and auditors, the responsibilities and powers of audit institutions, audit procedures, and the legal liability of auditors. The PRC had no independent audit institutions from 1949 until December 1982, when the National People’s Congress adopted a resolution to establish an auditing system in the PRC. Because of this resolution, the China National Audit Office (CNAO) was established in September 1983. The Auditor General who is a member of the State Council heads the CNAO. The CNAO audits public sector organizations (including many State-owned enterprises). It is also responsible for leading, developing, and supervising the auditing profession – it does not conduct financial attest audits.

After a 30-year hiatus, the first public accounting firm was established in the PRC in 1981. Much has happened in the ensuing 20 years – the PRC now has a thriving CPA profession. In the past two years, domestic accounting firm mergers have been actively encouraged. With the removal of restrictions – firms were previously legally allowed to only cover a single specific region – a number of accounting firms have

merged. The Big Five international accounting firms are all present in the PRC.

Professional Infrastructure

The Chinese Institute of Certified Public Accountants (CICPA) was established in 1988 and is now one of the world's largest professional accounting bodies, with around 135,000 individual members and 4,800 group members (CPA firms). While the Institute is nominally an independent organization, it is under the direct supervision and direction of the Ministry of Finance (major policies must be approved by the MOF). The *Certified Public Accountants (CPA) Law 1993* governs its activities. Since 1991, aspiring CICPA members must have an approved accounting degree, pass a uniform CPA examination, and demonstrate appropriate practical experience to gain membership. Some 530,000 candidates sat the examination in 2000, making it one of the world's largest practising-certificate examinations. CICPA members must undertake Continuing Professional Education to remain a member.

Accounting and Auditing Standards

In the 1950s, the PRC adopted a highly centralized administrative system from the Soviet Union (uniform accounting systems). In the early 1990s, it was decided that a series of basic and specific accounting standards that would be consistent with international accounting practices and that would cater to Chinese realities should be developed. In 1992, the Ministry of Finance issued the first of the PRC's new IAS-based accounting standards – Accounting Standards for Business Enterprises – No. 1 *Fundamental Accounting Standards*. A further ten standards have been issued since and more are on the drawing board. With the release of the first new accounting standard, the Ministry of Finance published a series of new uniform accounting systems for the major economic sectors. The Ministry of Finance is responsible for developing accounting standards but does so on advice from the China Accounting Standards Committee (CASC) which has seven members drawn from various backgrounds. With one exception, there are no significant differences between the PRC's accounting standards and IAS. The significant difference involves the requirement to agree; divergences from regulations (to comply with relevant accounting standards), and provisions for damaged or obsolete inventories, with the relevant authorities.

In the past six years, CICPA has developed a series of Independent Auditing Standards for the private sector, which are consistent with International Standards on Auditing. The CNAO has issued 38 Government Auditing Standards – these are currently being reviewed with ADB assistance.

Education and Training

Before 1978, the teaching methods for accounting was virtually a replica of the Soviet system. The accounting major was reintroduced into universities and colleges in 1978. A new accounting curriculum was introduced in the late 1980s – changes involved the introduction of core courses covering: accounting principles, intermediate financial accounting, advanced financial accounting, management accounting, cost accounting, financial management, and auditing. New textbooks were prepared and teaching materials were updated to reflect the new curriculum. Accounting academics recently examined accounting education and identified the following systemic weaknesses which, in the opinion of workshop attendees, are overstated: poorly-defined accounting education objectives, poor design of accounting majors, a weak curriculum system that does not fully reflect the needs of a mixed-market economy, poor compilation of textbooks, and lack of teaching consistency.

The 500 higher-education institutions that offer accounting majors include 23 universities and colleges that provide specialized CPA-oriented education. These institutions produced 1,500 graduates in 1999. In addition, three more schools specializing in CPA education are to be opened in Beijing (National Accounting Institute), Shanghai (Shanghai Accounting Institute), and Guangdong in the next year. A rudimentary estimate, based on an average of ten teaching staff at each of the 500 institutions teaching undergraduate accounting, is that the PRC has about 5,000 accounting teachers (higher education). A ‘self-sponsored’ training approach is taken to their development. Accounting professors and lecturers do not however, receive formal training. For instance, the target-training group for the National Accounting Institute does not include accountancy professors and lecturers.

Government Budgeting and Accounting

While the PRC’s fiscal deficit has remained comparatively low in the past 20 years, there is increasing concern about public finance arrangements. These concerns center on the use of extra-budgetary

funds (surtaxes, levies, and user charges accruing to government and administrative units) and the growing identification of public sector wastage and mismanagement. In recognition of these issues, the Ministry of Finance, with support from the United Nations Development Program (UNDP), the World Bank and the International Monetary Fund (IMF), is currently examining options for budgetary reform with the intention of designing a comprehensive program to overhaul the PRC's budget procedures.

The aggregate budget is prepared on a cash basis – the Government also prepares a consolidated balance sheet, which includes information on the level and composition of debt. Individual budget units use modified cash accounting. Their reports include cash information, which is consolidated for aggregate budgeting and reporting requirements. Not-for-profit organizations (e.g., schools, kindergartens, hospitals) have recently moved from cash accounting to a modified form of accrual accounting. While there are no firm plans for government organizations to report in accordance with International Standards, a research study into the feasibility of developing accounting standards for government organizations will be conducted as part of the World Bank-supported *Accounting Reform Project*.

Donor Assistance

The **ADB** is supporting broad governance activities through the technical assistance program. Directly relevant projects include:

- TA No-1483-PRC: *Audit Administration of the PRC* (\$600,000: 1991–1995). This TA improved the CNAO's capacity to audit externally-assisted projects.
- TA No. 3103-PRC: *Strengthening the Government Audit System* (\$700,000: 1999–2001). This TA is providing assistance to help strengthen the Government's audit system to conform to the requirements of the *Auditing Law 1994* and, as far as practicable, international standards on auditing.
- Pipeline 2001: *Strengthening the Accounting Profession* (\$600,000: 2001). The recommendations from this study will be considered when the details of this TA are decided.

The **World Bank** has been the major provider of external assistance in relation to the development of accounting and auditing arrangements. Projects include:

- *Financial Sector Technical Assistance (FSTA) Loan* (\$60 million: 1992–). In the period 1992–1995, the Ministry of Finance’s Task Force on Accounting Standards prepared 25 accounting standards in harmony with International Accounting Standards (IAS).
- *Fiscal Technical Assistance Project* (\$50 million: 1995–2001). Despite the 1995 starting date, very little was accomplished under this project until April 2000, with completion of a comprehensive Public Expenditure Management Review, by a World Bank team. A plan to reform and computerize government budgeting and accounting systems and procedures is currently being developed – the plan is drawing on the findings of the PEM, and will be implemented using the funding set aside in the Fiscal Technical Assistance Project.
- *Technical Assistance to the CNAO* (\$487,000: 1997–2000). Technical assistance has been provided to the Foreign Funds Application Audit Department (FFAAD) of the CNAO to: establish a management information system that will enable the FFAAD to efficiently and accurately collect and distribute audit data among its nationwide network of offices; familiarize senior FFAAD management with the experiences of Supreme Audit Institutions in performance auditing; enhance the skills and knowledge of selected senior FFAAD auditors in specialized areas of accounting and auditing practice with an emphasis on performance auditing, and establish a core training program to develop the knowledge and skills of auditors in areas of modern audit theory and practices.
- *Accounting Reform and Development Project* (\$33 million: 1999–2004). This project is building upon the FSTA project – its objectives are to further strengthen the caliber and training of members of the accounting profession and to develop and promulgate additional accounting standards. The project has three components: (i) to establish the National Accounting Institute which will be a Beijing-located residential facility that can accommodate up to 1,500 students at one time; (ii) to strengthen CICPA through the provision of computers, software and other essential equipment; and (iii) to develop and disseminate further accounting standards.

The **IMF** and the **UNDP** are working together with the World Bank on public expenditure management and treasury management. **AusAID** (Australia) is supporting a five-year, \$11 million, capacity-building program to help strengthen the public sector. The program has supported Australian training for nine middle-ranking managers from

the CNAO on state-owned enterprises auditing. The suitability of computerized audit approaches was also investigated. A key output will be a Financial Statements Audit procedures manual for conducting audits of SOEs. Multimedia and information technology specialists have worked with CNAO who will produce highly interesting inter-active training material for CNAO's auditors conveying the content of this manual. Canadian International Development Agency (**CIDA**) has provided training support to the CNAO. The German Technical Assistance Agency (**GTZ**) is providing ongoing support to the CNAO, in particular, to the Continuing Education Centers.